

Message Text

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ACTION EB-08

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TO SECSTATE WASHDC 9900
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USLO PEKING

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STATE PASS TREASURY FOR OASIA MARESCA

EO 11652: N/A
TAGS: EFIN, HK
SUBJECT: BANKING: HONG KONG PROPOSES TO TAX "OFFSHORE" LOAN PROFITS

1. IN EARLY MARCH, HONG KONG'S FINANCIAL SECRETARY, PHILIP HADDON-CAVE, ANNOUNCED THAT THE HKG WOULD BEGIN TAXING CERTAIN PROFITS FROM OFFSHORE ACTIVITIES OF BANKS MAINTAINING HK OFFICES. MUCH CONFUSION ABOUT THE HKG'S INTENTIONS AND THE AMBIT OF THE NEW TAX ENSURED; AND AMERICAN BANKERS WERE AMONG THE MOST VOCAL IN SEEKING CLARIFICATION FROM THE GOVERNMENT. ALTHOUGH HKG ESTIMATES OF ADDITIONAL REVENUE TO BE RAISED THROUGH THE NEW TAX WERE SMALL (\$31.3 MILLION IN 1978-79 AND \$17.4 MILLION IN SUBSEQUENT YEARS), MANY FOREIGN BANKERS FEARED THAT THEIR BURGEONING OFFSHORE

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LENDING ACTIVITIES WOULD NOW FACE HEAVY HONG KONG TAXES.

2. HADDON-CAVE RESPONDED TO THE FINANCIAL COMMUNITY'S QUERIES IN AN APRIL 12 SPEECH TO THE LEGISLATIVE COUNCIL. HE NOTED THAT THE TAX WOULD COVER NET PROFITS ON OFFSHORE LOANS ("NET" MEANING INTEREST RECEIVED MINUS INTEREST PAID AND RELATED OVERHEADS), ASSESSED AT THE STANDARD 17 PERCENT.

ONLY WHEN "THE PROFITS FROM INTEREST COULD BE SAID TO ARISE FROM OR THROUGH THE CARRYING ON OF BUSINESS IN HK," WOULD THE TAX BE CHARGEABLE, HADDON-CAVE SAID. HE STRESSED THAT, WHILE THE NEW TAX WOULD BE A REFORM OF HONG KONG'S INLAND REVENUE ORDINANCE, IT DID NOT ALTER HONG KONG'S BASICALLY FAVORABLE TAX TREATMENT OF BUSINESS. HADDON-CAVE FORESAW NO FINANCIAL INSTITUTIONS LEAVING HONG KONG, OR DECIDING NOT TO OPEN HONG KONG OFFICES, BEACUSE OF THE NEW TAX.

3. COMMENT. HADDON-CAVE'S "CLARIFICATION" DID NOT ENTIRELY ILLUMINATE THE NEW TAX PROVISIONS. PRECISELY WHEN A BANK'S HONG KONG OFFICE CAN BE JUDGED THE SOURCE OF (NOW TAXABLE) PROFITS ON AN OFFSHORE LOAN REMAINS UNCLEAR. PROFITS MADE ON FUNDS BORROWED IN HONG KONG BUT INVESTED OVERSEAS WOULD SURELY BE TAXED. PRESUMABLY, PROFITS FROM FOREIGN CURRENCY FUNDS BOTH BORROWED AND LENT ABROAD WOULD BE TAXABLE ONLY WHEN A BANK'S HONG KONG OFFICE, WITHOUT THE SUBSTANTIAL INTERVENTION OF A BRANCH OUTSIDE HONG KONG, MANAGED BOTH THE COLLECTION AND INVESTMENT OF THE FUNDS, AND PUT THE TRANSACTION THROUGH THE HONG KONG BANKING SYSTEM.

4. THE HKG WILL MOST LIKELY HAVE TO MAKE CASE-BY-CASE JUDGMENTS ON LIABILITIES FOR THE FIRST FEW YEARS OF THE NEW TAX'S ENFORCEMENT. IF THE BANKS DEMONSTRATED THAT THE NEW TAX HAD BECOME TRULY ONEROUS, THE HKG MIGHT WELL LIMITED OFFICIAL USE

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MODIFY IT, AS IT HAS IN THE PAST ALTERED POLICIES TO MOLLIFY CREDIBLE BUSINESS OPPOSITION. THE FINANCIAL SERVICES SECTOR HAS BECOME INCREASINGLY IMPORTANT TO HONG KONG AND NOW EMPLOYS ABOUT 3.5 PERCENT OF ITS WORKFORCE. WE DOUBT THAT THE HKG WOULD WANT TO RETARD ITS GROWTH. SHOESMITH

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